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ESTATE FREEZES AFTER THE REVENUE ACT OF 1987

by

RONALD D. AUCUTT*†

Last December, while tax professionals were still grappling with the Tax Reform Act of 1986,¹ Congress passed the Revenue Act of 1987.² Some Christmas present!

One of the most significant casualties of the 1987 Act was the popular planning tool known as the estate “freeze.”³ For decedents’ estates originating after December 31, 1987, any “freeze” completed after December 17, 1987 will be covered by the new law.⁴ There is no transition rule for transactions in progress.

Traditionally, estate freezing frequently could satisfy several planning objectives with one stroke. These objectives would commonly include: (1) minimizing estate taxes by shifting accretion in value of a client’s business interests; (2) providing for income to a client at retirement, and post mortem to the client’s surviving spouse; (3) avoiding probate administration on the transfer of certain assets; and (4) fixing a “lifetime” value for those assets which would otherwise pose problems for estate tax purposes.

The particular nature of each client’s business interest, when coupled with the complexion of the tax code, would dictate the choice to be made among various freezing techniques. Historically, perhaps the most popular technique has been the recapitalization of a closely-held (i.e., close) corporation. The corporate recapitalization⁵ typically involved an exchange by the older client of common stock for preferred stock, and the sale or gifting of common stock to the client’s children or younger associates. The value of the business was captured in the preferred stock, but any future appreciation of the business inured to the transferred common stock. Thus, there resulted not only a determination of the fair market value of the client’s interest in the business, but also a valuation which remained fixed or “frozen” in the client’s estate. In effect, the appreciation in the

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† Due to publication delays, this article does not reflect the impact of the July and August, 1988 Technical Corrections Bills.

¹ Pub. L. No. 99-514, 99th Cong., 2nd Sess. (1986).

² Omnibus Budget Reconciliation Act of 1987, Titles IX and X, Pub. L. No. 100-203, 100th Cong., 1st Sess. (1987).

³ Section 10402 of the 1987 Act added a new § 2036(c) to the Internal Revenue Code (IRC) of 1986, and redesignated former IRC § 2036(c) as IRC § 2036(d).

⁴ IRC § 2036(c)(1)(B); H.R. Rep. No. 100-495, 100th Cong., 1st Sess. 997 (1987) (Conference Report).

⁵ *Dean v. Commissioner*, 10 T.C. 19 (1948), acq. 1949-1 C.B. 1; *Hartzell v. Commissioner*, 40 B.T.A. 492 (1939), acq. 1939-2 C.B. 16.

value of the business from the date of the freeze to the date of the older client's death simply escaped the wealth transfer tax.⁶ Moreover, control of the business could be preserved through designating the client's shares as voting preferred and reissuing the common shares as nonvoting.

Similarly, for the business structured as a partnership, the elder-generation client became a limited partner while the younger-generation client continued as a general partner. The limited partner's capital account remained frozen in value, and the general partner's capital account was credited with the venture's growth.⁷ Another, more aggressive partnership freeze involved disproportionate allocations of profits, losses, or cash flow to reduce the elder generation's share, perhaps even to zero. This aggressive technique, however, was not possible if the younger generation's interest resulted from a gift and capital was not a material income-producing factor,⁸ and in any event is much more difficult under the new I.R.C. Section 704(b) regulations.⁹

Some other techniques have been employed alone or in combination with a corporate recapitalization or partnership freeze to satisfy clients' needs. Familiar examples include buy-sell agreements,¹⁰ certain stock restrictions and options, using "S" corporations as partners,¹¹ installment sales, loans coupled with purchases, private annuities, charitable lead trusts, sales of remainder interests,¹² and grantor retained income trusts (GRITs). Another approach has been joint purchases. In one application of this technique, the elder generation purchased a life estate or a term of years and the younger generation purchased the remainder. Another application was for a marital trust to buy the life estate and the credit shelter trust to buy the remainder.

Policy Arguments

Criticism of estate freezes has centered on the fact that these techniques operate essentially as testamentary substitutes. Such a "loophole" in the estate tax provisions would be especially subject to manipulation where the transferor and transferee of the property were within the same family. In effect, while purporting to transfer a part of the interest in the business to a younger generation, the elder generation continues to enjoy the fruits of the business — much as in a classic retained life estate.

Moreover, any "business" arrangement between family members, including

⁶ *Estate of Boykin v. Commissioner*, 53 TCM (CCH) 345 (1987).

⁷ This technique was recognized in *Estate of Meyer v. Commissioner*, 58 T.C. 311 (1972), nonacq. 1975-1 C.B. 3, *aff'd per curiam*, 503 F.2d 556 (9th Cir. 1974).

⁸ I.R.C. § 704(e).

⁹ Treas. Reg. § 1.704-1(b).

¹⁰ *But see* Treas. Reg. § 20.2031-2(h); *Dorn v. United States*, 828 F.2d 177 (3d Cir. 1987).

¹¹ *See* Letter Ruling 8804015. *But cf.* Rev. Rul. 77-220, 1977-1 C.B. 263.

¹² *But see* *Gradow v. United States*, 11 Cl. Ct. 808 (1987).

an alleged sale for fair value, is necessarily suspect. Although, since 1977, gift tax valuation errors can be corrected in the computation of the estate tax,¹³ this correction only determines the starting point of the graduated estate tax rates, and therefore it has only a limited effect, and no effect at all in the case of very large gifts.

The government simply finds it increasingly difficult to police valuation abuses whether in the form of non-arm's-length deals or in the form of non-arm's-length conduct subsequent to deals.¹⁴ This was particularly true during the late 1970's and early 1980's when interest rates, and thus appropriate rates of return on preferred interests received in a freeze transaction, were at unprecedented high levels. There was therefore great pressure to augment a less-than-market rate of return with "bells and whistles" such as conversion rights, powers to liquidate, or other rights not intended to ever be exercised and possibly even vanishing at death.

Other policy considerations are raised in defense of these freeze techniques, however. Primarily, it is appropriate as a matter of policy to assist — not penalize — small businesses, which contribute greatly to the economy. Small businesses should be able to defend themselves against a 55% estate tax. Moreover, a person should be able to give away an asset, such as a share of stock, as a completed transaction. Penalties and other deterrents to abuse are far more sensible measures than the broad sweep of a generalized legislative ban.

In a related vein, it is appropriate for parents to give children the incentive of an equity interest and to encourage risk-taking incrementally, while the parents can still prevent or correct excesses. And it is especially appropriate to shift the growth to children at a time when that growth more and more is attributable to the efforts of the children. Further, appreciation can never be guaranteed; often values decline. Both the possibility of appreciation and the risk of loss are reflected in fair market value determinations. In a value-for-value exchange, the anticipated income from the frozen interest is economically equivalent to the potential appreciation in the growth interest. Indeed, in a perfectly efficient economy, there is no such thing as a "freeze," and in an imperfect economy a "freeze" is only one form of "gamble" that pays off. It is not appropriate as a matter of policy to create new hindrances to entrepreneurship.

THE NEW LAW

Section 2036(C):

Inclusion Related to Valuation Freezes.

1. In General. — For purposes of subsection (a), if —

A. any person holds a substantial interest in an enterprise, and

¹³I.R.C. § 2001(b)(1)(B); Technical Advice Memorandum 8447005.

¹⁴See Rev. Rul. 83-120, 1983-2 C.B. 170.

- B. Such person in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in such person's interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise, then the retention of the retained interest shall be considered to be a retention of the enjoyment of the transferred property.
2. Special Rule for Sales to Family Members. — The exception contained in subsection (a) for a bona fide sale shall not apply to a transfer described in paragraph (1) if such transfer is to a member of the transferor's family.
3. Definitions. — For purposes of this subsection —
- A. Substantial Interest — A person holds a substantial interest in an enterprise if such person owns (directly or indirectly) 10% or more of the voting power or income stream, or both, in such enterprise. For purposes of the preceding sentence, an individual shall be treated as owning any interest in an enterprise which is owned (directly or indirectly) by any member of such individual's family.
- B. Family. — The term "family" means, with respect to any individual, such individual's spouse, any lineal descendant of such individual or of such individual's spouse, any parent or grandparent of such individual, and any spouse of any of the foregoing. For purposes of the preceding sentence, a relationship by legal adoption shall be treated as a relationship by blood.
- C. Treatment of Spouse. — An individual and such individual's spouse shall be treated as one person.
4. Coordination with Section 2035. — For purposes of applying Section 2035, any transfer of the retained interest referred to in paragraph (1) shall be treated as a transfer of an interest in the transferred property referred to in paragraph (1).
5. Coordination with Section 2043. — In lieu of applying Section 2043, appropriate adjustments shall be made for the value of the retained interest.

GENERAL OPERATION OF IRC SECTION 2036(c)

The "bottom line" result of I.R.C. Section 2036(c) is a deemed "retention of the enjoyment of the transferred property."¹⁵ To the extent that a growth interest in an enterprise is transferred while a frozen interest is retained, the transfer is "caught" by I.R.C. Section 2036(c) and "brought back into" the transferor's gross estate, at the transferred interest's then value.¹⁶

¹⁵I.R.C. § 2036(c)(1).

¹⁶I.R.C. § 2036(c) applies even in the case of annual exclusion gifts of \$10,000 or less per donee.

Examples:

1. *H* (husband) owns all the stock — common and preferred — of a corporation. He gives 60% of the common stock to *D* (daughter) and retains the preferred stock. The value of the common stock at the date of *H*'s death is included in his gross estate.
2. If, instead, *H* gives *D* 20% of the common stock and 20% of the preferred stock, Section 2036(c) does not apply.
3. If, instead, *H* gives *D* 80% of the common stock and 20% of the preferred stock (a combination of Examples 1 and 2), 60% of the common stock is included in his gross estate.¹⁷

The breadth of I.R.C. Section 2036(c) is staggering. Although the above examples deal with corporate recapitalizations, comparable results would occur not only with partnership interests but also with any other interests in an enterprise. Moreover, it is immaterial that the donees in the above examples are members of the donor's family, because no language in the provision limits the range of transferees. Conceivably, therefore, a gift to charity would be within the ambit of Section 2036(c).¹⁸ Also a matter of consternation is the extent to which, as in these examples, Section 2036(c) impacts not only on *H*'s estate but also on *W*'s (Wife's). In example 3 above, for instance, the provision as enacted apparently includes the gift of common stock in *W*'s estate also,¹⁹ a result that is not rationally within the scope of Section 2036(c).

SPECIAL RULES

First, for the new provision to apply, Section 2036(c)(1)(A) and (3)(A) establish a threshold test whereby the transferor and transferor's family must together own (directly or indirectly) at least 10% of the voting power or income stream of the enterprise.

Examples:

1. Wife (*W*) owns 1% of the voting common stock and 2% of the nonvoting preferred stock of a corporation. No one else in the family has any interest in the corporation. *W* gives the common stock to *S* (son). Section 2036(c) does not apply.
2. *W* owns 1% of the voting common stock and 2% of the nonvoting preferred stock of a corporation. *D* owns 12% of the voting common stock. *W* gives her common stock to *S*. The common stock is included in *W*'s estate.

Second, Section 2036(c)(2) differentiates family members from all other classes of potential transferees. This provision causes the same result where either

¹⁷ Conference Report, *supra* note 4, at 996.

¹⁸ Even if there were an offsetting charitable deduction for estate taxation, there would be uncertainty for the donor where the charity sells the stock before the donor's death. See *infra* text accompanying note 34.

¹⁹ I.R.C. § 2036(c)(3)(C).

a gift or a sale is effected to a family member.²⁰

The definition of "family," given by Section 2036(c)(3)(B), is utilized for attribution as well as transferee purposes. Essentially, the definition encompasses the individual's spouse, their respective lineal relatives (from grandparents on down), and those relatives' spouses. Although adopted descendants are included, collaterals (most notably, brothers and sisters) are not included. Hence, the individual's parents-in-law qualify as family members but the individual's uncle or nephew does not.

Further, Section 2036(c)(3)(C) states that "An individual and such individual's spouse shall be treated as one person." For example, *H* gives common stock to *S* and *D* and preferred stock to *W*, retaining nothing for himself. The common stock is includible in *H*'s gross estate because, with *H* and *W* deemed as one person, *H* has effectively retained the preferred stock.²¹

Third, the new law alters the treatment of consideration as between family and non-family transferees.²² Although I.R.C. Section 2036(c) treats the transferor as having retained enjoyment of the transferred property, it is I.R.C. Section 2036(a) that actually includes the value of the property in the transferor's gross estate.²³ The general rule is that I.R.C. Section 2036(a) does not apply to "a bona fide sale for an adequate and full consideration in money or money's worth." For example, *W* sells common stock to *N* (niece or nephew) for full consideration in cash, retaining preferred stock. The common stock is not included in *W*'s gross estate. However, a different result obtains under I.R.C. Section 2036(c)(2), which removes the "bona fide sale" exception in intrafamily transfers. Hence, if *W* sells the common stock to *S* (instead of *N*) for full consideration in cash and retains the preferred stock, then the common stock is included in *W*'s gross estate. For this purpose, corporate recapitalizations and other value-for-value exchanges are sales for consideration, even if the party involved is the entity, rather than other family members.

Moreover, IRC Section 2043(a) does not apply, according to IRC Section 2036(c)(5).²⁴ Instead, "appropriate adjustments shall be made for the value of the retained interest." This paragraph was intended to at least provide the result that

²⁰For any non-family transferee, § 2036(a) excepts a bona fide sale from the clutches of § 2036(c). See the discussion *infra* text accompanying note 24, regarding treatment of consideration.

²¹Likewise, the common stock is apparently includible in *W*'s estate. But if this latter result is correct, then *H*'s estate should receive a marital deduction for the stock he gave to *S* and *D*! A technical correction is obviously needed here.

Note however that the example in the text is only a special case. The application of I.R.C. § 2036(c)(3)(C) is not so limited. Using the basic example where *H* gives common stock to *D* and retains preferred stock, the common stock is again apparently included in *W*'s estate as well as in *H*'s. Such a result is obviously too broad.

²²See *supra* text accompanying note 20.

²³See Appendix B, proposed § 2036(c)(4).

²⁴Without amendment, § 2043 would not apply in this example anyway, because full consideration had been paid.

Section 2043(a) would have provided, allowing an offset for the consideration received.²⁵ As enacted, however, Section 2036(c)(5) is indecipherable without a technical correction. Nevertheless, an argument can be advanced that Section 2036(c)(5) should be expanded to allow compounding of the consideration to the date of transferor's death. This approach is correct if Congress's objective is to reconstruct the result that would have occurred had the sale not been made at all and the transferor had simply held the growth interest until death.²⁶

Fourth, IRC Section 2036(c)(4), as originally drafted, provides for coordination with IRC Section 2035, the "three-year rule." In general, where the client retains the preferred shares until his death, his Federal gross estate will include the date-of-death value of both the preferred shares and those common shares transferred during his lifetime.²⁷ But where the retained interest is transferred within three years before death, the growth interest is still brought back into the gross estate.

For example: *W* owns all the stock, common and preferred, of a corporation. *W* gives the common stock to *D* on February 1, 1988, and the preferred stock to *S* on January 1, 1993. If *W* dies January 2, 1996, or later, then none of the stock is included in her gross estate. If, however, *W* dies, say, November 1, 1995, then the common stock — and possibly also the preferred stock — is included in her gross estate.

Section 204(o) of the pending technical corrections bill, H.R. 4333 and S. 2238, would dramatically amend I.R.C. Section 2036(c)(4).²⁸ If this "technical correction" is enacted, then, in a situation covered by Section 2036(c), if during the original transferor's lifetime, either the transferee retransfers the transferred property outside of the family or the original transferor transfers the retained interest, within or outside the family, there would in effect be an acceleration of the tax. In other words, the amount that would have been included in the original transferor's gross estate under Section 2036(c) if the transferor had died at that time would be treated as a current gift by the transferor,²⁹ and Section 2036(c) would no longer apply to that transferred property for estate tax purposes when the original transferor dies.³⁰ If less than all of the transferred interest is retransferred or less than all of the retained interest is transferred, then this acceleration would be effected with respect to that portion.

²⁵ Conference Report, *supra* note 4, at 996-97.

²⁶ Note the identical results in Appendix A for Examples D (a Section 2036(c) sale, assuming compounding) and F (no transfer at all).

²⁷ IRC § 2036(c)(4) and 2035(d)(2). According to the Conference Report, *supra* note 4, at 995-96: The value of the transferred property is includible in a decedent's gross estate, if the decedent retained the interest for his life, for any period not ascertainable without reference to his death, or for any period which does not in fact end with his death. *** The provision only makes certain property includible in the estate; it does not affect the valuation of such property for estate tax purposes.

²⁸ See Appendix B.

²⁹ Proposed I.R.C. § 2036(c)(4)(A).

³⁰ Proposed I.R.C. § 2036(c)(4)(B).

For example (the same example as immediately above): *W* owns all the stock, common and preferred, of a corporation. *W* gives the common stock to *D* on February 1, 1988, and the preferred stock to *S* on January 1, 1993. Under the technical correction, *W* would be treated as having made a gift of the common stock, as well as the preferred stock, on January 1, 1993. Likewise, if *D* gave the common stock to charity on January 1, 1992, or sold the common stock to an outsider on January 1, 1992, *W* would be treated as having made a gift of the common stock on January 1, 1992. In either case (a transfer by *W* or a retransfer outside *W*'s family by *D*), nothing would be included in *W*'s gross estate by reason of Section 2036(c), even if *W* did not survive for three years.

The apparent purpose of the proposed amendment is to provide a gift tax analogue to the estate tax result of Section 2036(c), so as to prevent avoidance of the consequences of Section 2036(c) by subsequent transfers. Without such an amendment, it would be possible, for example, for a 40-year-old client to "freeze" an interest in an enterprise by transferring a growth interest, such as common stock, to children, and then transfer the "frozen" interest to children at age 65. Under the statute as originally drafted, if the parent survived another three years, 25 years of appreciation would effectively escape transfer tax. The proposed new Section 2036(c)(4) would tax that appreciation at the time of the second gift.

This amendment would answer some of the questions that were raised immediately after enactment of Section 2036(c), such as the consequences if following an estate freeze the entire enterprise were sold to outsiders.³¹ But on balance the proposed amendment has still caused great consternation, and at the very least needs considerable refinement. The amendment would simply treat the original transferor as having made a gift equal to the amount that would hypothetically be included at that time in the transferor's gross estate. But Section 2502(a)³² which provides for the computation of the gift tax, does not contain a coordinating rule analogous to the last sentence of Section 2001(b),³³ which provides for com-

³¹ This amendment, however, would not answer all the questions presented by subsequent transfers. See *infra* note 51.

³² I.R.C. § 2502(A):

- (a) Computation of tax. — The tax imposed by section 2501 for each calendar year shall be an amount equal to the excess of —
 - (1) a tentative tax, computed under section 2001(c), on the aggregate sum of the taxable gifts for such calendar year and for each of the preceding calendar periods, over
 - (2) a tentative tax, computed under such section, on the aggregate sum of the taxable gifts for each of the preceding calendar periods.

³³ I.R.C. § 2001(A):

- (b) Computation of tax. — The tax imposed by this section shall be the amount equal to the excess (if any) of —
 - (1) a tentative tax computed under subsection (c) on the sum of —
 - (A) the amount of the taxable estate, and
 - (B) the amount of the adjusted taxable gifts, over
 - (2) the aggregate amount of tax which would have been payable under chapter 12 with respect to gifts made by the decedent after December 31, 1976, if the provisions of subsection (c) (as in effect at the decedent's death) had been applicable at the time of such gifts.

For purposes of paragraph (1)(B), the term "adjusted taxable gifts" means the total amount of the taxable gifts (within the meaning of section 2503) made by the decedent after December 31, 1976, other than gifts which are includible in the gross estate of the decedent.

putation of the estate tax, to prevent a double gift tax on serial transfers. Under the proposed amendment, if common stock is given to children in one year and preferred stock given the following year, the common stock will be subject to a double gift tax, even if it does not appreciate in value at all.

In addition, the proposed new Section 2036(c)(4) does not specify to whom the deemed gift is considered made. The donee of this deemed gift could be important in determining the applicability of the annual gift tax exclusion,³⁴ the charitable deduction,³⁵ or the generation-skipping transfer tax.³⁶

This amendment would apparently permit the statute to have a cascading effect. Example: *H* and *S* each own preferred stock of a corporation. *H* owns all the common stock. *H* gives the common stock to *S*. *S* subsequently gives the common stock to his child, *GC*. The common stock apparently is included in the estates of both *H* and *S* when they die, because of their retention of preferred stock. If *GC* transfers the common stock outside of the family, it appears that both *H* and *S* would be deemed to have made a give.

The description accompanying the technical corrections bill, prepared by the staff of the Joint Committee on Taxation, included the following illustration:

[A] person who holds all the stock in a corporation and gives away the common stock while retaining all of two classes of preferred stock would be treated as making a gift under the provision only to the extent that he subsequently transfers a proportionate amount of each class of preferred stock. If he subsequently transfers 25% of one class and 75% of the other class of preferred stock, he would under the provision be treated as making a gift with respect to only the 25% of the common stock with respect to which proportionality was restored. His estate would still include 75% of the common stock — the share for which disproportionate ownership continues to exist after the subsequent transfer.³⁷

The requirement that “proportionality” be “restored” as to all classes of preferred stock considered separately will inevitably produce the wrong result. In the example stated, if it is assumed that each share of preferred stock has any value at all, then clearly the transferor has retained less than 75% of all the preferred stock. It would make more sense to combine the two classes of preferred stock for this purpose. For example, if the two classes were the same size, then 50% of the common stock in the stated example should be removed from the scope of Section 2036(c).³⁸

³⁴ Section 2503(b).

³⁵ Section 2522.

³⁶ Section 2601 *et. seq.*

³⁷ Staff of the Joint Committee on Taxation, *Description of the Technical Corrections Act of 1988 (H.R. 4333 and S. 2238, 425 (March 31, 1988))*.

³⁸ Like the rest of § 2036(c), the proposed new § 2036(c)(4) would raise many questions about its scope. For example, even payments on an installment sale note would arguably be partial dispositions of the transferor-seller's retained interest, creating tremendous complexity.

The proposed technical correction would also direct the Service to "prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection [*i.e.*, Section 2036(c)], including such regulations as may be necessary or appropriate to prevent avoidance of the purposes of this subsection through distributions or otherwise."³⁹ This appears intended to prevent the technique of diluting the value of an enterprise through distributions to younger-generation owners.⁴⁰

Example: *H* owns all the common and preferred stock of a corporation. In 1988 *H* gives all the common stock to *S* and *D*. By 1995, the common stock has greatly increased in value. If income tax rates in 1995 are still lower than estate tax rates, even the payment of dividends to *S* and *D* with respect to their common stock would put more money in the hands of *S* and *D*, after taxes, because it would dilute the value of the common stock and save estate tax at *H*'s death. If it is possible to make corporate distributions to *S* and *D* with respect to their common stock without dividend treatment, this technique is even more valuable.

The contemplated regulations presumably would prevent this result.⁴¹

DIFFICULT STATUTORY TERMS

Although the debate over estate freezes is ancient, the immediate germ of Section 2036(c) is the following suggestion of congressional staffs:

The parent's estate could include the full value of property which is effectively subject to the retained life interest (*i.e.*, the common stock as well as the preferred stock, in the recapitalization case . . .).⁴²

When the House Committee on Ways and Means acted upon this suggestion, it was reported as follows:

If an owner of a substantial interest in an enterprise transfers a disproportionate share of the appreciation in the enterprise while retaining disproportionate control or income of that enterprise, the transferred interest would be included in his gross estate.⁴³

Most estate planners who were aware of these developments thought they knew what these concepts were aimed at. But when these *concepts*, and very little more, were arranged into paragraphs and subparagraphs and presented as a *statute*,

³⁹ Proposed I.R.C. § 2036(c)(6).

⁴⁰ See *supra* note 37, at 426.

⁴¹ Like the rest of § 2036(c), this new provision would seem to operate only one way, adversely to clients. For example, although it appears aimed at distributions to younger-generation owners, it is not at all clear that it contemplates that the younger-generation owners' subsequent contributions to capital would be given the reverse effect.

⁴² Staff of the Joint Committee on Taxation, *Description of Possible Options to Increase Revenues* 266 (June 25, 1987).

⁴³ Staff of the Joint Committee on Taxation, *Summary of Ways & Means Committee Action on October 13, 1987*, at 22.

no one knew what they meant anymore. Much of the astonishing breadth, as well as the exasperating uncertainty, of Section 2036(c) can be analyzed by considering the various concepts which, undefined or loosely defined, found themselves serving as statutory terms.⁴⁴

"Substantial interest." As a threshold for the mechanics of IRC Section 2036(c) to be brought into play, the transferor and the transferor's family must have owned a "substantial interest" in the enterprise.⁴⁵ The parenthetical "directly or indirectly" increases the reach of the threshold test by expanding what both the transferor and the transferor's family are deemed to own. By design and in operation, this provision is aimed at tiered entities.

Examples:

1. *W* owns one percent of the voting common stock and two percent of the nonvoting preferred stock of a corporation. All the rest of the stock of the corporation is held by a trust created and funded by *W*'s uncle in 1981. The trust beneficiaries are *D* and *S*, and the trustee is *X* Bank. In 1988, *W* gives her common stock to *D* and *S*. *D* and *S*, beneficiaries of the trust, are treated as owning all the stock owned by the trust. Therefore, *W* and her family, *D* and *S*, are treated as owning all the stock of the corporation — clearly a "substantial interest" — and the common stock given in 1988 is included in *W*'s gross estate.

This provision, however, operates only for purposes of the "substantial interest" threshold test, not for purposes of determining a retained interest in the enterprise. For example:

2. *W* owns all the common stock of a corporation. All the preferred stock of the corporation is held by a trust created and funded by *W*'s uncle in 1981. The trust beneficiaries are *D* and *S*, and the trustee is *X* Bank. In 1988 *W* gives the common stock to *D* and *S*. The preferred stock is treated as owned by the trust beneficiaries, *D* and *S*. Although it would therefore be attributed to *W* for purposes of the "substantial interest" threshold test, it is not attributed to *W* as a retained interest in the corporation. Therefore, *W* has retained no interest in the corporation, and Section 2036(c) does not apply.

Although the above examples deal with a trust, the result would be the same with respect to any pass-through entity. Thus, the interest in an enterprise owned

⁴⁴Commentators have universally noted the great breadth and ambiguity of the statute. See, e.g., Belcher & Wood, *Section 2036(c): Has the Ice Age Arrived for Estate Freezes?*, 13 ESTATES, GIFTS & TRUSTS J. 63 (1988); Bettigole, *Use of Estate Freeze Severely Restricted by Revenue Act of '87*, 68 J. TAX. 132 (1988); Blattmachr & Gans, *Putting The Heat on Freezes*, PROBATE & PROPERTY 12 (May/June 1988); Covey, U.S. Trust-Practical Drafting, April 1988, at 1415; Foster & Rabun, *Planning Strategies to Cope with the Limits Imposed on Estate Freezes by RA '87*, 15 ESTATE PLANNING 130 (1988); Keydel, *The Internal Revenue Code's New "Anti-Freeze" Provision*, 34 PRACTICAL LAWYER 11 (1988); Mahon, *Poorly Conceived Statute Is Bad for Business*, TRUST & ESTATES 45 (May 1988); Treanor, *The Revenue Act of 1987: Estate Valuation Freeze*, TAX MGT MEMORANDUM (1988).

⁴⁵IRC §§ 2036(c)(1)(A) and (3)(A).

by a partnership would be attributed to the partners, and the interest in an enterprise owned by a corporation would be attributed to the shareholders. Such attribution is applied successively in complex multi-tiered structures.

The 10% threshold test applies to the ownership of voting power, income stream, or both.⁴⁶ Here, "voting power" probably includes the right to vote stock held in trust, as exercisable by a fiduciary or by holders of the voting trust certificates.⁴⁷ The reference to "income stream" conceivably may include interest on debt, consultant's or director's fees, deferred compensation or retirement arrangements, or even intrafamily royalties or rent. This may be largely academic, however, because the interests of the whole family are aggregated for this purpose anyway. The allocation of "income" or other rights among respective family members is not important to the threshold "substantial interest" test.⁴⁸

"*Enterprise.*" The term "enterprise" in Section 2036(c)(1)(A) is said to include "a business or other property which may produce income or gain."⁴⁹ A plain language interpretation nets a meaning broad enough to include an investment company, co-owned assets, and even unimproved real estate. But to interpret it to include such assets as cash and marketable securities would simply render the 10% "substantial interest" test irrelevant.

"*Holds.*" In Section 2036(c)(1)(A), the phrase "any person holds a substantial interest" apparently contemplates the status quo before the transaction. To illustrate: *H* owns 12% of all the stock, voting common and nonvoting preferred, of a corporation. In 1988, *H* gives half the voting common stock to *N*. The stock *H* retains represents less than 10% of the voting power and income stream of the corporation. No other member of his family has any interest in the corporation. Yet the stock *H* gives to *N* in 1988 is included in his gross estate, because *H* owned a "substantial interest" in the corporation before making the gift. But if *H* gives the balance of his common stock to *N* in 1990, then Section 2036(c) should not apply, because *H* (together with his family) does not hold a substantial interest in the corporation in 1990. Thus, the 1988 gift will be included in his gross estate, but the 1990 gift should not be.

If, however, *H* had given all his common stock to *N* in 1988, it would then all be included in *H*'s gross estate. This result suggests both the opportunity for advantages timing and the likelihood that step-transaction rules will be invoked in some cases.⁵⁰

⁴⁶I.R.C. § 2036(c)(3)(A).

⁴⁷*Cf.* § 2036(b).

⁴⁸Compare discussion *infra* notes 59-62, where for purposes of § 2036(c)(1)(B) a broad interpretation of "income" is by no means academic.

⁴⁹Conference Report, *supra* note 4, at 996.

⁵⁰Note that transfers two years apart are collapsed in Proposed Treas. Reg. § 20.2036-2(e)(4), *Example (1)*.

“After December 17, 1987.” One would ordinarily not think that the phrase “after December 17, 1987” was ambiguous. While its principal purpose is to grandfather pre-December 18, 1987, freeze transactions, however, even this reference in Section 2036(c)(1)(B) raises serious questions of interpretation in its application to serial transfers.

Assume in each of the following examples that *W* owns 80 percent of the common and preferred stock of a corporation:

1. *W* gives *D* all her common stock. The common stock will, of course, be included in her gross estate.
2. Alternatively, assume that in 1988 *W* gives *S* half her common stock (40%). Then in 1990 she gives *S* half her remaining common stock (20%) and half her preferred stock (40%). If the 1988 and 1990 gifts are each viewed in isolation, then 40% of the common stock (the subject of the 1988 gift) will be included in *W*'s gross estate. But no stock will be subject to Section 2036(c) by reason of the 1990 gift, because *W* gave the same proportion of each class of stock she owned. If the gifts are viewed in the aggregate, however, *W* will have given *S* 60% of the corporation's common stock and 40% of the preferred stock, and only the difference — 20% of the common stock — is subject to Section 2036(c).⁵¹
3. Alternatively, assume that in 1988 *W* gives half her preferred stock (40%) to *S*. Presumably Section 2036(c) does not apply to a gift of only preferred stock. Then in 1990 *W* gives three-fourths of her common stock (60%) to *S*. If the gifts are viewed in isolation, it appears that 60% of the common stock is included in *W*'s gross estate. But because this result is the same as in Example 2, perhaps only 20% — or 40%? — should be included in her gross estate. On the other hand, it might be argued that this result is not the same as in Example 2, because *W* has postponed the “freeze” in this example and thereby has arguably obtained less benefit from it. If so, it is hard to tell how this factor should be quantified.⁵²

“Disproportionately large.” Despite the difficulties with other terms in the statute, there is no question that the most troublesome terms in the new statute are “disproportionately large” and “in effect.” Under Section 2036(c)(1)(B), the estate tax consequences of Section 2036(c) are triggered when a person with a substantial interest in an enterprise in effect transfers after December 17, 1987, property having a disproportionately large share of the potential appreciation in

⁵¹ The proposed “technical correction” of Section 2036(c)(4) apparently is intended to produce the latter result. The accompanying staff description refers to a removal from Section 2036(c) of the “percent of the common stock with respect to which proportionality was restored.” Description, *supra* note 37 at 425. In the example in the text, therefore, *W* would presumably be treated as making a gift of an additional 20% of the corporation's common stock in 1990, and 20% of the corporation's common stock would be subject to Section 2036(c) upon her death. But the answer is by no means clear from the language of the proposed statute itself.

⁵² It was perhaps too much to be hoped that the pending “technical correction” would shed any light on this example. It does not. The answer may have to await further technical corrections, regulations, or even litigation.

such person's interest in the enterprise while retaining a disproportionately large share in the income of, or rights in, the enterprise.

The ink was barely dry on the President's signature when a great debate arose whether Section 2036(c)(1)(B) contains two tests (one relating to "appreciation" and another relating to "income" or "rights") or just one test. Originally, it was almost universally assumed among practitioners and commentators⁵³ that there are two tests, and that it is therefore possible by ingenious planning and drafting to create estate freezes that fail one test but not both. One possibility might be a gift by a parent to a child of participating or convertible voting preferred stock with a cumulative dividend that exceeds the dividend on the conventional preferred stock the parent retains.

But another question that arose very early about the term "disproportionately large" is "Disproportionate to what?" One answer supplied by the context is that the two "shares" of Section 2036(c)(1)(B) — the share of potential appreciation and the share of income or rights — are compared *to each other*. So analyzed, the second question provides the answer to the first: there is only one test, stated two different ways. If one share "proportionately" goes down, the other share *must* "proportionately" go up.⁵⁴

The disproportionality test, then, is a matter of comparing ratios of ratios — the ratio of an individual's interest in the potential appreciation of an enterprise to his or her total interest in the enterprise before the transfer, compared to the same ratio recomputed after the transfer.

This comparison is easier to illustrate than to describe: For example: *H*, who owns all the stock of a corporation, gives 49% of the common stock to *D*. He retains a majority of the potential appreciation — 51%. Nevertheless, because he began with 100% of the potential appreciation, he has reduced his *share* of potential appreciation — from 100% to 51%. Moreover, because he has not reduced his share of preferred stock at all, he has reduced his share of potential appreciation *disproportionately*. Thus, Section 2036(c) applies, and the transferred common stock is included in his gross estate.⁵⁵

⁵³ See, e.g., Belcher & Wood, *supra* note 44, at 65; Covey, *supra* note 44, at 1415.

⁵⁴ Although the metaphor may be more intriguing than illuminating, the author has colloquially described this phenomenon by pointing out that to be "less awake" is the same as to be "more asleep." Perhaps more to the point, it is impossible to transfer a disproportionately large share of the frosting without retaining a disproportionately large share of the cake.

⁵⁵ It could be argued that a transfer of potential appreciation is never "disproportionately large" if the transferor, as in the example in the text, retains more potential appreciation than he transfers. See Covey, *supra* note 44, at 1419. See generally Foster & Rabun, *supra* note 44, at 132. This argument derives its force from the statement of managers in the conference report, which states: "A disproportionately large share of potential appreciation is any share of appreciation in the enterprise greater than the share of appreciation borne by the property retained by the transferor." Conference Report, *supra* note 4, at 996. It is difficult to see the policy justification for such a rule; the transfer of a remainder interest in less than half of any property, for example, has always been caught by § 2036(a). In any event, it is apparent that the conference report does not mean what it appears to say in absolute terms, but must be applied in a comparative manner as illustrated in the text. For example, the Ways and Means Committee report, commenting on language in the House bill that

Using identical facts as above, except that *H* also gives *D* 48% of the preferred stock, *H* has now substantially *reduced* his share in the income of, or rights in, the corporation. Nevertheless, because even the substantially-reduced share he retains is larger than the share of potential appreciation he retains, his retained share is "disproportionately large." Section 2036(c) applies, and 1% of the common stock is included in *H*'s gross estate.

Another great debate has revolved around the application of Section 2036(c) to voting and nonvoting stock for example, although not exclusively, in an S corporation. Some commentators assumed early that Section 2036(c) should not apply to the transfer of nonvoting stock and the retention of otherwise identical voting stock.⁵⁶ Increasingly uneasy about the prospect that congressional staffs might have intended the statute to apply to such a transfer, other commentators have concluded that the answer is not clear⁵⁷ and that such a transfer might be caught.⁵⁸

Viewed as a matter of policy, there seems to be no reason to attempt to distinguish between a block of nonvoting stock and a minority block of voting stock. Viewed as a matter of statutory construction, however, it is possible to bring voting and nonvoting stock within the range of Section 2036(c)(1)(B). Although at first blush two classes of stock, one voting and one nonvoting but otherwise identical, do not seem to present an opportunity to transfer "a disproportionately large share of the potential appreciation," this necessarily assumes that appreciation is allocated proportionately to the control premium represented by the right to vote. If appreciation is allocated less than proportionately to that control premium, then the conditions of Section 2036(c) appear to be satisfied.

Example: *H* owns all the 100 shares of voting common stock and all the 100 shares of nonvoting common stock of a corporation. The value of the corporation is assumed to be \$210,000, allocated \$1,000 to each share of nonvoting stock and \$1,100 to each share of voting stock. Assume that *H* gives the nonvoting stock to *D*. Assume further that subsequently the corporation roughly doubles in value, to \$415,000, but the value of the right to vote increases only 50%, from \$100 to \$150 per share. The \$415,000 value of the corporation is therefore allocated \$2,000 to each share of nonvoting stock and \$2,150 to each share of voting stock. *D*'s nonvoting stock has appreciated 100% (from \$1,000 to \$2,000 per share) while *H*'s retained voting stock has appreciated only 95.45% (from \$1,100 to \$2,150 per share). It is arguable that *H* has transferred to *D* a disproportionately large share of the appreciation.

was not materially different on this point in the ultimate conference report, stated: "A disproportionate share need not be substantially disproportionate within the meaning of § 302(b)(2)(C)." H.R. Rep. 100-391, 100th Cong., 1st Sess. 1044 (1987). In other words, a disproportionate share could be less than 20% of the transferor's interest. Similarly, the staff description of the pending technical corrections bill liberally cites examples where no more than half of the transferor's interest in potential appreciation is transferred. Description, *supra* note 37, at 424-25.

⁵⁶ E.g., Bettigole, *supra* note 44, at 133.

⁵⁷ E.g., Mahon, *supra* note 44, at 50.

⁵⁸ E.g., Belcher & Wood, *supra* note 44, at 68.

In any event, when it is remembered that the word “disproportionately” invites a comparison to the transferor’s entire interest, including the right to vote, than a “potential-appreciation-per-vote” analysis emerges, by which Section 2036(c) might be found applicable, without regard for the control premium.

For example: *W* owns all of the 100 shares of voting common stock and all of the 100 shares of nonvoting common stock of a corporation. She gives *D* half of her nonvoting common stock. She has given away one-fourth of the potential appreciation, compared to none of the voting rights — a “disproportionately large share of the potential appreciation.” Put another way, she has retained 100% of the voting rights, compared to only 75% of the appreciation potential — a “disproportionately large share in the . . . [voting] rights,” even if she retains only 75% of the income.

If there is a possibility that Section 2036(c) will be applied to voting and nonvoting stock, then considerable care must be taken in advising clients about *any* arguable “transfer.” Voting trusts, powers of attorney, and even pledges as security for loans will be suspect. Further, every limited partnership may be deemed to have voting (general) and nonvoting (limited) interests, and even a general partnership may have a “voting” managing partner.

The terms “income” and “rights” in Section 2036(c)(1)(B) are very broad, perhaps even broad enough to include interest and compensation. For instance, there may be no difference between debt and preferred stock for purposes of Section 2036(c). If so, then, interest on debt is within the scope of “income.” To illustrate: *W* owns common stock and corporate notes. She gives the stock to *S*. Because of *W*’s retention of the notes, the stock is included in *W*’s gross estate.⁵⁹

The problem of interest and compensation might prove to be one of the most important and controversial issues raised by Section 2036(c). While it is easy to say that corporate notes are treated like corporate stock, an indiscriminate application of Section 2036(c) to loans will lead to peculiar results. How would one account for a “loan” or other extension of credit arising in the ordinary course of business, such as an open account? What about a loan to a child who is a shareholder? Or a loan to a child even if there is no corporation? What about a loan, or even an ordinary gift, to a child which the child uses to start or invest in an unrelated business? How are such loan or gift proceeds traced?

As to a parent’s services to a family enterprise, the receipt of compensation might be the retention of an income interest, but the rendering of services without compensation might itself be a taxable gift. It may be that if *W* is employed by the corporation, her salary must be cut in half if she is to give *S* half of her common stock without triggering Section 2036(c). (Even that might not work unless

⁵⁹ See also the example involving corporate debt *infra* text accompanying note 66.

her duties and authority are also cut in half!)⁶⁰ Deferred compensation and retirement arrangements could create great complexity.⁶¹ Similar issues are presented by compensation for the use of property, such as rent or royalties. It is hoped that regulations take a reasonable approach to these issues.⁶²

The “retaining” test is also very broad, making it difficult to measure the effect of the transaction in many cases. Example: *H* gives all the common stock of a corporation to *S*, retaining only one share of \$100 preferred stock (or one \$100 corporate note, if debt is treated like stock). It would make no sense to treat the retention of a \$100 interest as the “retention of the enjoyment” of the entire corporation. But the statute gives no indication of how to draw a line in such cases.

The “disproportionately large” test is apparently intended to be applied at the time of the transfer. Consistent with the statute’s general one-way application, there is no provision for a “look-back” and therefore no relief if the enterprise declines in value. Section 2036(c) apparently applies even if it is expected from the beginning that the enterprise *will* decline in value and it is desired for some reason to shift that high risk of decline in value to younger-generation owners.⁶³

“*In effect.*” The words “in effect” are the coiled spring which could suddenly and unexpectedly project Section 2036(c) into so many business and non-business circumstances and which therefore have caused the greatest apprehension about the statute. It is this term which applies Section 2036 to any transaction or event which simulates a transfer of appreciable property, which achieves the same result that a transfer of appreciable property would achieve, or which when broken down into the tiniest of components could conceivably be reconstituted in the form of a transfer of appreciable property. Whenever such a transaction or event occurs, it will be necessary under the statute to test the transferor’s and transferee’s shares of potential appreciation compared to their shares of all income of and rights in the enterprise, before and after the transaction.

The transferor and transferee need not even both be parties to the “transfer” for purposes of Section 2036(c), because transactions with the business entity are analyzed for transfer tax purposes as if they are transactions among the owners of the beneficial interest in the enterprise, proportionately.⁶⁴ Thus, a redemption is “in effect” a transfer, and Section 2036(c) applies. For example, *H* owns 75%

⁶⁰ Under the general principles applicable to § 2036, however, the mere “right” to compensation would not be regarded as “retained” at the time of the transfer unless there were a legal commitment or express or implied understanding. Reg. § 20.2036-1(a); *United States v. Byrum*, 408 U.S. 125, 148-50 (1972).

⁶¹ This discussion is by no means exhaustive. As soon as one example is analyzed and the probable result predicted, a half-dozen new examples emerge. § 2036(c) is broad enough to cover a host of transactions and arrangements that would not otherwise appear to involve the capital structure of the enterprise.

⁶² There is no reason for § 2036(c) to deal with matters — such as the adequacy of interest or the reasonableness of compensation — that are amply addressed by other provisions of the law.

⁶³ See Scenario III in Appendix A, however, for an illustration of the computation when the value of the enterprise declines.

⁶⁴ See Reg. § 25.2511-1(h)(1).

of the common and preferred stock of a corporation. *S* owns the other 25%. *H* causes the corporation to redeem his common stock. The transfer to the corporation is treated as a transfer to *S*. Therefore, Section 2036(c) applies, even if the redemption proceeds are full consideration. If there are no other transactions, three-fourths of the value of *S*'s common stock is included in *H*'s gross estate.⁶⁵

Similarly, the issuance of stock by a corporation is "in effect" a transfer, and Section 2036(c) applies. For example: *H*, who owns all the common and preferred stock of a corporation, causes the corporation to issue common stock to *S*. Section 2036(c) applies, even if *S* pays full consideration. *S*'s common stock is included in *H*'s gross estate.

Clearly Section 2036(c) applies to ordinary corporate recapitalizations, which "in effect" are combinations of redemptions and issuances of stock.

Examples:

1. *H* owns 75% of the single class of common stock of a corporation. *S* owns the other 25%. *H* exchanges his stock for voting preferred stock in a tax-free recapitalization. Because *H* entered the transaction owning 75% of the potential appreciation, 75% of the value of *S*'s common stock is included in *H*'s gross estate.
2. *H* owns 75% of the single class of common stock of a corporation. *S* owns the other 25%. *H* exchanges his stock for corporate notes. If debt is treated the same as preferred stock⁶⁶ then 75% of the value of *S*'s common stock is included in *H*'s gross estate.⁶⁷

Although the examples immediately above deal with corporate transactions, similar results would obtain with respect to changes in the interests in any entity, such as a partnership.⁶⁸

In contrast, Section 2036(c) apparently might not be applied to buy-sell agreements. Although granting an option to buy may be viewed as a transfer of part of the "bundle of property rights,"⁶⁹ and Section 2036(c) reportedly was intended by its drafters to apply to such a "transfer," its written legislative history suggests that it is not aimed at issues that historically have been regarded as valuation issues.⁷⁰

Whether the creation of a new enterprise constitutes a "transfer" under Section 2036(c) remains unclear, especially when the enterprise begins as a "joint"

⁶⁵ This result is the same whether or not the redemption escapes dividend treatment under § 302(b). This could be the result in the case of so-called "leveraged buyouts."

⁶⁶ See *supra* text accompanying note 59.

⁶⁷ This result is the same whether or not the exchange escapes dividend treatment under § 302(b).

⁶⁸ Some have even suggested that the amendment of a partnership agreement merely to conform to the new partnership allocation rules under Treas. Reg. § 1.704-1(b) could be construed as creating a transfer, in effect, of potential appreciation.

⁶⁹ *Dorn v. United States*, 86-2 USTC ¶13,701 (W.D. Pa. 1986, rev'd, 828 F.2d 177 (3d Cir. 1987)).

⁷⁰ Conference Report, *supra* note 4, at 996.

or “split” purchase of a life estate and a remainder. It can be argued that if there is no “enterprise” for purposes of Section 2036(c)(1)(A) and no before-and-after shares of potential appreciation to test for purposes of Section 2036(c)(1)(B), then Section 2036(c) does not apply.

Examples:

1. *W* and *D* form a corporation with cash. *W* receives preferred stock and *D* receives common stock. Section 2036(c) apparently does not apply.
2. Same as Example 1 except that *D* received her cash as a gift from *W*. Section 2036(c) may not apply.
3. *W* forms a corporation with cash and receives common and preferred stock. She immediately gives (or sells) the common stock to *D*. Because in substance this is the same as Example 1 (if a sale) or 2 (if a gift), the result should be the same. Section 2036(c) should not apply. (But prudence would dictate avoiding this form of transaction.)

Any line-drawing with Section 2036(c) is difficult, but these suggested results regarding the creation of a new enterprise and a joint purchase are especially hard to reconcile. It is probable that a joint purchase of a conventional life estate and remainder will be covered by Section 2036(c),⁷¹ but it is very hard in some cases to distinguish such a joint purchase from the joint creation of a corporation which issues preferred and common stock.

There are yet more unanswered questions. In Example 1 immediately above, what if nonbusiness income-producing assets, such as passive rental real estate, royalty interests, or Government securities, were contributed to the new corporation instead of cash. In Example 2, what if a loan were used instead of a gift? In Example 3, how long is “immediately?”

It is the judgment of this author that all these questions should be resolved in favor of a finding that Section 2036(c) does not apply to the interests received upon the creation of a new enterprise, because that transaction most resembles a “gamble.”⁷² To the extent that there is a policy justification for a rule like Section 2036(c), it seems to this author that it is limited to the freeze of an interest in a going concern with proven appreciation potential.

Moving to a slightly different context, what would be the result if the enterprise underwent a change of form? In general, where there is a pre-existing enterprise and before-and-after shares to test, Section 2036(c) applies. For example, an incorporation of a partnership or sole proprietorship is treated for this purpose like a recapitalization, not like the creation of a new enterprise.

⁷¹ The example that is circulating among estate planners is 100 share of stock in a publicly-held corporation, in which a father buys a life estate for cash and his child buys the remainder for cash. It is generally assumed that § 2036(c) could catch such an arrangement, although it certainly stretches the conventional understanding of the term “enterprise” to apply it to 100 shares of stock in a huge publicly-owned corporation.

⁷² See *supra* text following note 14.

Perhaps the most ironic phenomenon of all is that the “antifreeze” provisions of Section 2036(c) could apply to an “unfreezing” transaction. For example: In a pre-1987 recapitalization, *H* received all the preferred stock of a corporation and *S* received all the common stock. Now the preferred stock dividend has become a burden to the corporation, and *H* no longer needs it. But *H* might be deemed to have made a gift to *S* if the dividend is not paid.⁷³ *H* therefore converts his preferred stock back into common stock. If *S* predeceases *H*, Section 2036(c) might apply.⁷⁴

CONSEQUENCES OF SECTION 2036(c)

Appendix A presents an analysis of the total estate and gift tax liabilities under various scenarios — comparing a gift, a sale, and no transfer at all, with and without Section 2036(c).

There are also a number of indirect and incidental consequences of the application of Section 2036(c). The includability of previously transferred property in the transferor's estate under Section 2036(c) could increase the estate's eligibility for stock redemption under Section 303, deferral of estate tax under Section 6166, and possibly special-use valuation under Section 2032A. Such property would receive a new income-tax basis at death equal to its estate tax value.⁷⁵ If the property is then in the hands of a person more than one generation below the generation of the transferor, a generation-skipping transfer tax could be imposed.⁷⁶

The interplay with local law may present very difficult issues of tax appointment. State appointment statutes might not give the executor the right to pursue the owners of non-probate assets included in the Federal gross estate but not the probate estate.⁷⁷ In any event, tax clauses in wills should be reconsidered, and payment of the tax should be a planning objective.

WHAT'S LEFT? REMAINING FREEZE TACTICS

Any article on Section 2036(c) should have a section entitled “What's Left?” But this section might most honestly be left blank. The language of Section 2036(c) is so broad that it is almost impossible to cite any example to which it certainly will not be applied.

⁷³ Technical Advice Memoranda 8403010 and 8723007. See also Technical Advice Memorandum 8726005.

⁷⁴ But since there was no “transfer of property” from *S* to *H* (only possibly a deemed transfer “in effect”), the ultimate irony is that the credit for tax on prior transfers under § 2013 might not be available when *H* subsequently dies. Note that all the other examples presented in this article presuppose transfers (or deemed transfers “in effect”) from an older generation to a younger generation. It is hazardous to approach § 2036(c) with any presuppositions whatsoever.

⁷⁵ I.R.C. § 1014(b)(9).

⁷⁶ Under proposed § 2642(f), which would be added by Section 114(g)(5) of the pending technical corrections bill (H.R. 4333 and S. 2238), the allocation of the generation-skipping transfer tax inclusion ratio would be suspended until death in a case to which Section 2036(c) applies.

⁷⁷ Even transferee liability under § 6901 would be problematic in the case of a deemed transfer “in effect.”

One possibility is that any entity freeze may continue to be effective, if the frozen interest is automatically extinguished, shifted, or converted to a growth interest before death. An example might be a so-called "GRIT preferred interest" such as preferred stock which freezes an estate, but which is automatically converted after a term of years or the occurrence of a specified event to common stock, thereby "unfreezing" the estate.⁷⁸ Such interests take their names from the so-called grantor retained income trust, which they resemble. For that matter, any grantor retained income trust should continue to escape Section 2036(c),⁷⁹ although, of course, it will be caught by Section 2036(a) if the grantor dies within the term. If the grantor survives the term of years, Section 2036(a), as expanded by Section 2036(c)(1), might not apply. In addition, even Section 2036(c)(4) (either as originally enacted or as the proposed technical correction would amend it) might not apply, because it requires a "transfer" and is not modified by the expansive "in effect" language of Section 2036(c)(1)(B). This interpretation, of course, cannot be guaranteed. Moreover, any GRIT arrangement is obviously not a totally reliable estate planning device, because survival for the necessary period can never be assured.

A "capital shift" partnership freeze might still be available. For example: *W* owns a conventional partnership interest. *D* owns a "preferred" partnership interest with a right to a very large return on capital, say 20%, payable only from net income but cumulative to the extent not paid. The partnership cumulative obligation to *D* with respect to her preferred interest dilutes the value of *W*'s interest. *W*'s estate would argue that Section 2036(c) does not apply, because *W* retained the "residual" appreciation potential. On the other hand, the IRS would be expected to argue that Section 2036(c) should be applied to such an arrangement on a facts-and-circumstances or substance-over-form theory.

The possibility that the joint creation of a "new enterprise" might not be covered by Section 2036(c) has already been discussed.⁸⁰ In addition, a post mortem joint purchase freeze, wherein a marital trust buys a life estate or term of years and a credit shelter trust buys a remainder in assets not previously owned by either, might continue to be effective, because the identity of the transferor and transferee are less clear. Indeed, if the marital trust is a QTIP trust, it is conceivable that the marital trust and credit shelter trust would have exactly the same terms and beneficiaries. In any joint purchase, a term of years might be better than a life estate, to strengthen the case if the elder purchaser survives the term, as in a GRIT.

⁷⁸ If § 2036(c) is interpreted to apply to debt instruments, then the simplest example of a GRIT-type interest might be an installment sale note. Another important GRIT-type arrangement is a fixed-term partnership.

⁷⁹ See Bettigole, *supra* note 44, at 134; Blattmachr & Wood, *supra* note 44, at 17; Covey, *supra* note 44, at 1430-32; Foster & Rabun, *supra* note 44, at 133. The "transfer" occurs when the GRIT is created. Letter Rulings 8815005 & 8805029. *But see* Belcher & Wood, *supra* note 44, at 69 (suggesting that a GRIT is caught by Section 2036(c) unless the grantor survives the termination of the GRIT by three years).

⁸⁰ See *supra* text following note 70.

Buy-sell agreements might escape Section 2036(c), but such an agreement will still fail if it is “a device to pass the decedent’s shares to the natural objects of his bounty for less than an adequate and full consideration in money or money’s worth.”⁸¹

A *Dean-Hartzell* type recapitalization might still work, if notes are used instead of preferred stock, if the notes are kept as clean (of equity features) and short-term as possible, and if section 2036(c) is interpreted not to apply to debt. In any event, substantial appreciation can still be removed from the estate by transferring interests in an enterprise with only one class of ownership, or a proportional share of all classes of ownership held by the transferor.

Finally, no estate freeze technique should be categorically discarded. If there are business or other non-tax reasons for the freeze transaction, the freeze should be considered. To the extent that Section 2036(c) is interpreted to merely reproduce the tax result that would have obtained if no initial transfer had been made, then there might be little or no downside tax risk in the transaction.⁸²

CONCLUSION

Section 2036(c) is very broad. No significant adjustment in the relationships of the owners of an enterprise should be undertaken without considering its possible reach. Although Section 2036(c) serves a questionable need, it probably will not be repealed.⁸³ Moreover, it appears very difficult to draft appropriate language that would limit Section 2036(c) to a reasonable scope. For that reason, the best development in the interpretation of Section 2036(c) would be the prompt issuance of regulations or similar guidance with lots of examples — examples both of the extreme cases, so the public will understand the principles involved, and of the borderline cases, so the public will understand where lines are to be drawn.

⁸¹ Reg. § 20.2031-2(h). See *Dorn v. United States*, 828 F.2d 177 (3d Cir. 1987). Cf. Technical Advice Memorandum 8710004 (stock redemption agreement).

⁸² See Appendix A.

⁸³ Some practitioners have suggested that § 2036(c) might be replaced by additional disclosure requirements, beefed-up undervaluation penalties, and extended statutes of limitations. This author has reservations about relying on such mechanisms. Valuation of a closely-held business is necessarily an extremely subjective matter, and the reopening of valuation questions years after transactions have been completed could work tremendous mischief.

APPENDIX A

COMPUTATIONS

Assumptions:

1. In 1993 *H* owns, or receives in a recapitalization, all the common stock of a corporation, valued at \$1,000,000, and all the preferred stock of the corporation, valued at \$1,000,000 and paying an annual dividend of \$100,000. (The 10% yield is consistent with the current valuation tables in Reg. § 20.2031-7.) *H*'s after-tax income from these dividends is \$70,000.
2. *H* gives (in Examples A and B) or sells (in Examples C, D, and E) his common stock to *D* and *S* in 1993. (He does nothing in Example F.) Income tax on the sale is disregarded.
3. All *H*'s cash compounds at a rate of 10% annually.
4. *H* dies in 2003, having made no other gifts (or sales of stock).
5. At the time of his death, *H* owns other property with a value of \$1,000,000.
6. I.R.C. § 2036(c) is taken into account in Examples A, C, and D, but for comparison purposes is assumed not to have been enacted in Examples B and E. (It is irrelevant in Example F.)
7. I.R.C. § 2036(c)(5) is interpreted to provide an offset for consideration without compounding (like § 2043(a)) in Example C and an offset for consideration compounded at 10% annually in Example D.
8. There are no material changes in the law.

SCENARIO I
Common Stock Appreciates 20% Annually

	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>F</i>
1993 Transfer	Gift	Gift	Sale	Sale	Sale	None
§ 2036(c) Applies?	Yes	No	Yes	Yes	No	
Compounding under § 2036(c)(5)?	Yes	No	No	Yes		
a) Common Stock	6,191,736		6,191,736	6,191,736		6,191,736
b) § 2036(c)(5) Adjustment			-1,000,000	-2,593,742		
c) Preferred Stock	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
d) Preferred Dividends, Compounded	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620
e) Less \$153,000 Gift Tax, Compounded	-396,843	-396,843				
f) \$1,000,000 Sale Proceeds Compounded			2,593,742	2,593,742	2,593,742	
g) Other Property	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
h) <i>H</i> 's Gross Estate	8,910,513	2,718,777	10,901,098	9,307,356	5,709,362	9,307,356
i) Adjusted Taxable Gifts		1,000,000				
j) Total	<u>8,910,513</u>	<u>3,718,777</u>	<u>10,901,098</u>	<u>9,307,356</u>	<u>5,709,362</u>	<u>9,307,356</u>
k) Tentative Tax	4,231,057	1,635,189	5,271,404	4,429,478	2,630,481	4,429,478
l) Less Gift Tax	-153,000	-153,000				
m) Estate Tax	4,078,057	1,482,189	5,271,404	4,429,478	2,630,481	4,429,478
n) Less Unified Credit	-192,800	-192,800	-192,800	-192,800	-192,800	-192,800
o) Total Federal and State (Soak-up) Estate Taxes	3,885,257	1,289,389	5,078,604	4,236,678	2,437,681	4,236,678
p) Add Back Gift Tax, Compounded	396,843	396,843				
q) Total Taxes, Compounded	<u>4,282,100</u>	<u>1,686,232</u>	<u>5,078,604</u>	<u>4,236,678</u>	<u>2,437,681</u>	<u>4,236,678</u>

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SCENARIO II
Common Stock Appreciates 10% Annually

	<i>A</i> Gift Yes	<i>B</i> Gift No	<i>C</i> Sale Yes No	<i>D</i> Sale Yes Yes	<i>E</i> Sale No	<i>F</i> None
1993 Transfer						
§ 2036(c) Applies?						
Compounding under § 2036(c)(5)?						
a) Common Stock	2,593,742		2,593,742	2,593,742		2,593,742
b) § 2036(c)(5) Adjustment			-1,000,000	-2,593,742		
c) Preferred Stock	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
d) Preferred Dividends, Compounded	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620
e) Less \$153,000 Gift Tax, Compounded	-396,843	-396,843				
f) \$1,000,000 Sale Proceeds Compounded			2,593,742	2,593,742	2,593,742	
g) Other Property	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
h) <i>H's</i> Gross Estate	5,312,519	2,718,777	7,303,104	5,709,362	5,709,362	5,709,362
i) Adjusted Taxable Gifts		1,000,000				
j) Total	<u>5,312,519</u>	<u>3,718,777</u>	<u>7,303,104</u>	<u>5,709,362</u>	<u>5,709,362</u>	<u>5,709,362</u>
k) Tentative Tax	2,432,060	1,635,189	3,427,352	2,630,481	2,630,481	2,630,481
l) Less Gift Tax	-153,000	-153,000				
m) Estate Tax	2,279,060	1,482,189	3,427,352	2,630,481	2,630,481	2,630,481
n) Less Unified Credit	-192,800	-192,800	-192,800	-192,800	-192,800	-192,800
o) Total Federal and State (Soak-up) Estate Taxes	2,086,260	1,289,389	3,234,552	2,437,681	2,437,681	2,437,681
p) Add Back Gift Tax, Compounded	396,843	396,843				
q) Total Taxes, Compounded	<u>2,483,103</u>	<u>1,686,232</u>	<u>3,234,552</u>	<u>2,437,681</u>	<u>2,437,681</u>	<u>2,437,681</u>

SCENARIO III
Common Stock Declines in Value 10% Annually

	<i>A</i>	<i>B</i>	<i>C</i>	<i>D</i>	<i>E</i>	<i>F</i>
1993 Transfer	Gift	Gift	Sale	Sale	Sale	None
§ 2036(c) Applies?	Yes	No	Yes	Yes	No	
Compounding under § 2036(c)(5)?	Yes	No	No	Yes		
a) Common Stock	348,678		348,678	348,678		348,678
b) § 2036(c)(5) Adjustment			-1,000,000	-2,593,742		
c) Preferred Stock	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
d) Preferred Dividends, Compounded	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620	1,115,620
e) Less \$153,000 Gift Tax, Compounded	-396,843	-396,843				
f) \$1,000,000 Sale Proceeds Compounded			2,593,742	2,593,742	2,593,742	
g) Other Property	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
h) <i>H</i> 's Gross Estate	3,067,455	2,718,777	5,058,040	3,464,298	5,709,362	3,464,298
i) Adjusted Taxable Gifts		1,000,000				
j) Total	<u>3,067,455</u>	<u>3,718,777</u>	<u>5,058,040</u>	<u>3,464,298</u>	<u>5,709,362</u>	<u>3,464,298</u>
k) Tentative Tax	1,309,528	1,635,189	2,304,820	1,507,949	2,630,481	1,507,949
l) Less Gift Tax	-153,000	-153,000				
m) Estate Tax	1,156,528	1,482,189	2,304,820	1,507,949	2,630,481	1,507,949
n) Less Unified Credit	-192,800	-192,800	-192,800	-192,800	-192,800	-192,800
o) Total Federal and State (Soak-up) Estate Taxes	963,728	1,289,389	2,112,020	1,315,149	2,437,681	1,315,149
p) Add Back Gift Tax, Compounded	396,843	396,843				
q) Total Taxes, Compounded	<u>1,360,571</u>	<u>1,686,232</u>	<u>2,112,020</u>	<u>1,315,149</u>	<u>2,437,681</u>	<u>1,315,149</u>